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IS CONTRACT LAW NECESSARY?

Alan Schwartz

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**MAX WEBER PROGRAMME**

***Is Contract Law Necessary?***

**ALAN SCHWARTZ**

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## **Abstract**

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*Alan Schwartz*

*Sterling Professor of Law; Professor of Management, Yale University*



## **1. Introduction**

This Lecture argues that much of the contract law in the cases (the US, the UK and Canada) and in the codes (Europe and Latin America) is unnecessary. To say that a law is unnecessary is to say that it does not perform a useful social function. The argument below thus sets out the functions that contract laws today are thought to serve, and then shows that many of those functions either should not be performed at all or should be performed by institutions other than courts. Also, the unnecessary functions increase transaction costs because parties must contract away from or otherwise adjust to them.

It is helpful at the outset to set out the argument's domain. First, the argument applies to sophisticated parties, who usually are firms. Firms have enough at stake, and possess or can get sufficient expertise, to create written contracts. For these same reasons, firms often litigate over deals that do not work out. As a consequence, contract law primarily regulates transactions between firms. Second, the argument applies to the law that courts enforce. The common law is judge made. European Civil Codes are written on high levels of abstraction, and so much of the living law in Europe also is judge made.

It also is helpful to set out the norm that governs the argument. Western law is formally committed to the norm of freedom of contract; parties can make their own deals. An immediate implication of this commitment is that parties should be free to alter or reject parts of the state supplied contract law that do not advance the parties' interests. Western contract law follows this implication, at least in its formal statement. Thus, almost every provision of the US Uniform Commercial Code can be varied by agreement of the parties, and few sections of Civil Codes are explicitly made mandatory. It is customary to refer to rules parties can vary or avoid as defaults. A contract law is largely composed of defaults.

An apparent, but controversial, implication of the ubiquity of defaults holds that defaults should reflect majoritarian party preferences. If parties can vary or reject laws they dislike, then supplying parties with laws they dislike cannot advance any social goal. This simple point raises the question what do parties like. Firms contract to maximize gains from trade. As a simple example, if sellers have a comparative advantage at repairing defective machines, then the privately negotiated contract will require the seller to repair. But if defects sometimes are the result of buyer misuse, then the repair obligation will be carefully qualified. Parties in this circumstance will reject or alter a state supplied warranty that is not carefully qualified.

This analysis leads to the syllogism that governs this Lecture: (i) A contract law should implement the preferences over rules that firms typically have; (ii) Firms prefer rules that maximize their expected surplus from trade: that is, firms prefer efficient rules; (iii) Therefore, a contract law

should contain only efficient rules. Few contract law rules, it is argued below, can satisfy an efficiency test.

Before reaching the argument, it will be helpful to illustrate the institutional limitation noted above. Monopoly power is inefficient. This justifies the antitrust laws, which attempt to deter or curb monopoly power. Suppose then that a firm, arguably possessing monopoly power, qualifies its obligation to repair defective machines. Should a court strike the qualification if a buyer sues to obtain broader protection? This Lecture argues not. If the source of the seller's market power remains, the seller probably will supply buyers with repair clauses, or substitute other clauses, that buyers prefer less. Eliminating monopoly power is useful; judicial regulation of a monopolist's contracts is not.

## **2. The functions that Contract Law Serves**

The contract laws of Western states perform six functions:

- A. Enforce contracts.
- B. Interpret contracts.
- C. Police contracts for "procedural fairness". Unfairness takes four forms:
  - (i) The contract is induced by fraud.
  - (ii) A party is uninformed regarding payoff relevant variables because information is too costly for the party to acquire.
  - (iii) A party takes advantage of the counter-party's cognitive errors.
  - (iv) A contract is the consequence of monopoly power.
- D. Police contracts for "substantive fairness".
- E. Create defaults. These take two forms:
  - (i) Default rules.
  - (ii) Default standards.<sup>1</sup>
- F. Create mandatory rules.

Courts perform functions (A), (B) and (C)(i). The other functions are split, in complex ways, between legislatures and courts. To see how, realize that once a court has decided what the contract says, the court has only two available actions: to enforce the contested part of the contract; or, to not enforce the

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<sup>1</sup> A rule specifies permitted and proscribed behavior "in advance". For example, "Drive no more than 80 kilometers an hour" is a rule. A standard is meant to guide the adjudicator, who decides ex post what is permitted or proscribed. Thus, "Drive reasonably" is a standard. A court determines whether an agent had driven reasonably in the circumstances.



contested part. The legislature creates standards to guide courts in performing functions (C)(2-4) and (D). The standards often are drafted on such high levels of abstraction, however, that courts essentially perform these functions with little guidance. For example, authorizing a court not to enforce an “unconscionable” contract may relax judicial reluctance to intervene in contractual relationships, but does not tell the court what to do. The court has to create the applicable standard. It is the same when courts are authorized to strike “unfair” terms.

Legislatures put defaults and mandatory rules in codes. These defaults and rules, however, often are inducted from judicial decisions. Thus, courts decided to protect the promisee’s expectation interest – to award the promisee a sum equivalent to his net gain from performance – but the damage rule is now statutory.

### **3. Useful Contract Law Functions**

The enforcement function is of first order importance. Commercial parties write contracts in thick markets to allocate risk. For example, a manufacturer/buyer wants to reduce variance in input costs, so the buyer makes a supply contract. Parties write contracts in thin markets to protect relation specific investment. For example, a seller specializes her production facilities to meet the buyer’s particular needs; the specialized facilities would generate a low return in their next best use. In both cases, the counterparty has an incentive to breach. If market prices rise, the supplier prefers to sell on the market; after the seller has altered her machines, the buyer prefers to renegotiate the price so that it reflects low future costs, not high past costs. Legal enforcement materially reduces the incentive to breach, and so encourages parties to make supply and investment contracts.

The interpretation function also is of first order importance. To see why, realize that meaning is contextual: words such as “reliable” or “red” mean different things depending on how they are used. Hence, an important function of a written contract is to convey context information to a court, so that the court can recover the parties’ intentions. The more context data the court can recover, the more likely it is to interpret the contract accurately. And since parties write contracts to maximize expected gains, the parties’ expected payoff from a deal is increasing in the court’s accuracy. Describing context is costly, however. Hence, parties trade off contract writing cost against accuracy gain. In the usual case, context descriptions fall short of full: the parties would have said more had the cost to saying been less. This analysis implies that contracts require interpretation. When a dispute arises, the court must reconstruct, as best it can, the parties’ intentions from imperfect contract descriptions, the performance the seller rendered, and other evidence.

The “interpretive rules” guide courts in this task. Space constraints preclude discussing these rules in detail. This Lecture makes one point, that is a helpful bridge to the next subject. The interpretive rules are mandatory: courts decide what evidence to admit, how complete a contract description should be, and so forth. That these rules are mandatory is widely acceptable, but this

should surprise. A commitment to freedom of contract uncontroversially implies that parties can choose a contract's substantive terms: the price, the quality, the delivery time. It apparently follows that parties should be free to choose the rules that courts use to find those terms. No good answer to why not exists. In sum, the interpretation function is necessary, but the particular ways that Western courts carry out this function is not.<sup>2</sup>

#### **4. Policing for fairness: procedure<sup>3</sup>**

Individual persons may make inefficient or unfair contracts with firms because (a) many transactions, especially major ones, are "one offs" for persons, so individuals may not know how to conduct them. Firms, in contrast, make the same transaction repeatedly. Hence, firms are relatively more sophisticated than persons, and could use this knowledge to exploit; (b) persons lack training in reading contracts, and so may mistake the legal relationships those contracts create; (c) persons may make cognitive errors. Policing consumer contracts for fairness thus can increase welfare.<sup>4</sup>

These justifications for procedural policing either do not apply or weigh less heavily as applied to firms. Firms make repeated transactions, both as buyers and as sellers, and so generally understand those transactions. Also, for similar reasons, firms generally are competent and cognitively capable. Employees are unlikely to rise to important decision making positions in firms if the employees do not know how to do what the firm does, nor are employees likely to rise if they are cognitively challenged. And a firm that comes to be run by incompetents is likely to be competed out of business by more capable firms.

Finally, a modern economy requires capable firms. This need implies that the state should treat weak firms as if they were strong. Presuming competence for firms will have the effects of causing firms that cannot learn how to contract to fail and encouraging other firms to learn. Both effects are desirable. Thus, while there may be a case on fairness grounds to protect less capable persons, there is no good case for protecting less capable firms.

An objection to this analysis is that information may be too costly for firms to acquire, so even competent firms may make inefficient transactions. As an example, in a stock for stock merger, target shareholders must be well informed about the acquirer's business and plans in order for the shareholders to value the stock consideration. This objection is partly persuasive. Regarding the

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<sup>2</sup> The interpretation function is extensively discussed in Alan Schwartz and Robert E. Scott, "Contract Interpretation Redux", 119 Yale L.J. 926 (2010) and Same authors, "Contract Theory and the Limits of Contract Law", 113 Yale L.J. 541 (2003).

<sup>3</sup> Fraud is costly and socially useless, so policing contracts to deter fraud in the inducement or in carrying a contract out is socially desirable. This policing function is uncontroversial and so is not discussed here.

<sup>4</sup> An argument that European law regulates consumer contracts excessively because it assumes that consumers are weaker than they are in fact is in Gerhard Wagner, 'Mandatory Contract Law: Functions and Principles in Light of the Proposal for a Directive on Consumer Rights', 3 Erasmus Law Review 47 (2010).

persuasive part, the information gap is real. Regarding the unpersuasive part, courts should enforce merger contracts regardless.

Firms partly cure disclosure problems with self help. Target shareholders can reject acquisition offers that are unaccompanied by sufficient information to make valuation decisions. More particularly, if firm A wants firm T to accept A's stock in payment, then firm A will have to persuade T shareholders that the stock is worth what A claims. The ability to refuse to deal produces a large amount of disclosure.

There is a constructive role for the state to play, however. Regulation may require firms to make acquisition disclosures, and others, in standard ways. This will facilitate the ability of sellers to evaluate information, and to compare the offers of different firms. Disclosure schemes are best created and run by expert agencies. Courts lack the resources and expertise to intervene constructively. So in sum while the state can respond effectively to information gaps, it should police them with agencies, not courts. Policing business contracts for procedural fairness is unwise.

## **5. Policing for fairness: substance**

Contract codes commonly authorize courts not to enforce contracts that produce "unfair" outcomes, or that turn out to be "one-sided", or that "will work hardship" or that would effect an "unconscionable" result. These authorizations to review contracts are meant to protect the "weaker" party. A party is "weak" because of the procedural defects just discussed, however. The party is unsophisticated relative to his counter party, or uninformed or the like. Hence, policing a contract for substantive fairness must presuppose that there is no procedural unfairness. But if there is no procedural unfairness, then a party is not weak.

Another way to put this point is that policing contracts for substantive fairness is inconsistent with the justification for enforcing contracts. This justification, recall, is that parties are better than the state at advancing their interests *if* the parties contract in circumstances in which procedural unfairness is absent. A contract law that permits courts to review contracts for substantive fairness thus is incoherent: to permit contract is to presume party competence; to review for fairness is to presume party incompetence.

A weak objection to this point is that parties sometimes make mistakes, so that judicial rescue is helpful. This objection is weak on two grounds. First, the contract that a court substitutes for the contract the parties made is unlikely to be as efficient as the contract the parties made. Were courts better than parties at making contracts, the freedom of contract norm should be abandoned. Second, to rescue parties from mistakes is to encourage mistakes.

(Contd.) \_\_\_\_\_

A practical difficulty with policing contracts for substantive fairness is that the statutory standards – “unfair”, “weak” – are vague, and so encourage moral hazard. To understand what is meant, assume that parties make a contract under which the seller, a cement manufacturer, contracts to deliver  $Q$  tons of cement to the buyer, who is a builder. There are three possible states of demand in the buyer’s market when the seller is supposed to deliver the cement: demand turns out to be high because there is a lot of building; demand is average (similar to past periods); demand turns out to be low (there is a slump in the construction industry). The usual contract sets a fixed price for cement per ton, which reflects the cost of producing it. If this contract were not enforceable, the buyer would voluntarily accept the  $Q$  tons at the contract price in the high and average demand states; his value for the cement then exceeds the price. The buyer, however, would breach in the low demand state because his value for cement has fallen below the price. Contracts are made legally enforceable just to bind parties in states of the world in which they would prefer not to be bound.

Assume now that a court would not enforce a contract in the low demand state because the buyer would suffer a serious loss; he would have to pay a price that much exceeds the value of the cement to him. In the court’s view, the contract “bears too harshly on” the buyer. If courts act in this way, however, they defeat the institution of contract because, as said, the buyer would perform voluntarily in the other possible states. Put generally, parties perform contracts voluntarily in states of the world when legal enforcement would seem fair to an outsider, and prefer to breach contracts in states when enforcement would seem “unfair” to an outsider. A contract law therefore *exists to enforce substantively unfair contracts*.

In addition, the substantive policing doctrines create losses in the short run and pointlessly raise transaction costs in the long run. To see why, consider again the cement case. The seller functions in a competitive market, so the contract price equals her cost, which is assumed to be 50. In the high demand state, the buyer values the  $Q$  tons at 80; in the average state, he values the tons at 60; and in the low state, his valuation is 40. The market price when the buyer is supposed to take delivery, suppose, falls to 25 in the low demand state. Assume that the three possible future states are equally likely. In this illustration, the seller makes zero profits because price equals cost,<sup>5</sup> and the buyer makes an expected profit of 10 if the contract is enforceable in every state.<sup>6</sup>

The buyer does better than this, and the seller worse, if the buyer could exit the contract in the low demand state. His profit would then rise to 18.33 because he will purchase the  $Q$  tons at the low demand price of 25 when demand turns out to be low.<sup>7</sup> The buyer thus has a strong incentive to attempt to escape the contract in the low demand state by invoking the substantive policing doctrines.

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<sup>5</sup> The seller will earn a competitive return on the capital she invests in the business.

<sup>6</sup> Denoting the buyer’s expected profit as  $\pi$ , he earns  $\pi = (80 - 50)/3 + (60 - 50)/3 + (40 - 50)/3 = 30/3 = 10$ .

<sup>7</sup> If there is exit, then  $\pi = (80 - 50)/3 + (60 - 50)/3 + (40 - 25)/3 = 55/3 = 18.33$ .

The buyer's gain is the seller's loss because she must resell the cement for 25 in the low demand state.<sup>8</sup> The policing doctrines thus create an incentive for parties to escape bad deals and thereby to impose losses on their counter-parties.

In a more extended temporal frame work, the doctrines do not create redistributions, but raise transaction costs. This is because the price will increase to reflect the breach possibility. In this example, the price rises to 75. The seller would once more make zero profits and the buyer's expected gain would fall back to ten.<sup>9</sup>

Thus, when sellers anticipate buyer bad behavior, they adjust to it in the price. The cost of these adjustments is socially useless. The parties do as well in the adjusted state as they would have done had there been no substantive policing doctrines. Contract law thus would save transaction costs if it eliminated the substantive policing doctrines so that parties would know that their contracts are enforceable in all future states.

## 6. Rules and Standards

Laws, generally speaking, are cast in the form of rules or standards. European and US contract codes contain many more standards than rules. Standards and rules usually are defaults; they become implied terms in contracts unless particular parties contract out of them. Parties can write contracts on their own, however. Hence, the presence of statutory rules and standards raise three questions: (a) Why does contract law contain rules and standards? (b) Why are there more standards than rules? (c) Should contract law contain either rules or standards? An answer to (a) that is rejected here is that contract codes should draft rules for parties who lack the sophistication to create contract terms in their best interests. The answer is rejected for reasons set out above: firms either can write efficient terms themselves or should be given incentives to write them.

Continuing with question (a), there is a theoretical case for state created default rules: such rules sometimes are public goods. An example will illustrate the case. Consider the problem of creating a contract term that would specify the damages that a seller could collect if the buyer

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<sup>8</sup> The seller earns  $2/3(50) + 1/3(25) - 50 = -8.33$ . Hence, breach redistributes wealth from the seller to the buyer.

<sup>9</sup> If the buyer could escape legal enforcement, he maximizes profits by performing under the contract when he has a high valuation for the goods, but purchasing on the market, at the current market price, when his demand is average or low. The seller thus expects to recover the contract price when demand is high, and sell on the market when demand is average and low. Denote the contract price as  $x$  for this case. Since the seller earns zero profits in a competitive

market, and recalling that the three demand states are equally probable,  $x$  solves  $\frac{x}{3} + \frac{50}{3} + \frac{25}{3} - 50 = 0$ . The contract

price thus will be 75. At this price, the buyer's expected return is  $\frac{80-75}{3} + \frac{60-50}{3} + \frac{40-25}{3} = 10$ . Thus, the

seller earns zero profits whether the contract is enforceable or not, and the buyer earns the same return. Efficient damages in these contexts are analyzed in Alan Schwartz and Robert E. Scott, "Market Damages, Efficient Contracting, and the Economic Waste Fallacy", 108 Columbia Law Review 1610 (2008).

breached and the seller resold the goods at or close to the contract price. Creating the term would, it is assumed, create a 100€ benefit to a set of parties, but would cost the parties 120€ to create. The parties thus would not create the term. Suppose that the term, if it existed, would create benefits for 50 similar sets of parties. Then the total social benefit from having the term would be 5,000€. Now let the state consider creating a committee to draft the term as a default rule, and recommend it to the legislature for adoption. If the entire public process of rule creation costs less than 5000€, the state should enact the term as a default rule in its contract code.

This conclusion can be put formally. Let the cost to a set of private parties of creating a rule be  $c_i$ ; the benefit to a set of parties of having the rule be  $b_i$ ; the cost of a state created rule be  $s$ ; and there are  $n$  sets of parties that would benefit from the rule.<sup>10</sup> Then the state should create a default rule when two sets of inequalities are satisfied:

$$1) \sum_{i=1}^n b_i < \sum_{i=1}^n c_i$$

$$2) \sum_{i=1}^n b_i > s$$

The state should create a default rule, that is, when the total benefits private parties would realize from the rule is less than the total private costs (Expression 1), but the total benefits to private parties is greater than the state's total cost (Expression 2).

There are few rules in commercial codes because both of these inequalities are difficult to satisfy. State rule creation can be costly, but the real problem is party heterogeneity.<sup>11</sup> Continuing with the example above, suppose that it would cost the state 500€ to create the damage term but only three sets of parties would benefit. Then solving Expression (2) yields  $300 - 500 = -200$ €. It would be inefficient for the state to create the rule. Party heterogeneity is a problem because the solutions to many contracting problems are “parameter specific”; that is, the solutions vary with the identity of parties. Thus, in the seller damage example, the privately efficient solution is for the seller to require a nonrefundable down payment and a later transaction price that is paid only by buyers who voluntarily trade. The relative sizes of the down payment and transaction price vary with party valuations for trade and with market conditions. There is no generally applicable solution to the question of the damages a seller should receive when she sells the product a buyer rejected for the same price to another buyer.<sup>12</sup>

<sup>10</sup> Each party is identified by the subscript  $i$  so  $i \in \{1, 2, \dots, n\}$ .

<sup>11</sup> A general discussion of the heterogeneity concern is in Alan Schwartz, “The Normative Implications of Transaction Cost Economics”, 152 J. of Institutional & theoretical Economics 287 (1996).

<sup>12</sup> The damage problem the text discusses is analyzed in Alan Schwartz, “Price Discrimination with Contract Terms: The Lost Volume Problem”, forthcoming American Law and Economics Review (2010).

Therefore, contract codes primarily contain standards, or phrases that make rules partial standards.<sup>13</sup> The enterprise of statutory standard creation is incoherent.<sup>14</sup> The case for a state created rule is that the costs to parties of creating the term that could be cast as a rule exceeded the parties' benefit. It is almost costless to create standards, however. Thus, parties in the example above easily could draft a term authorizing the seller to collect "reasonable" damages when a buyer breaches. Parties do not write that standard, or anything similar. The inescapable inference from this gap is that private parties do not want a standard to govern the conduct at issue.

Parties reject standards for three reasons. First, it is more difficult for parties to predict the result of a litigation that turns on the application of a standard than a litigation that turns on the application of a rule. Thus, a law of standards reduces the ability of parties to predict how courts will judge their deals. Second, that standard applications are relatively unpredictable may encourage a party for whom a deal has turned out badly to breach and hope a court will rescue him. Third, the vagueness of a standard permits a court to substitute its judgment of what a reasonable transaction would be for the parties' judgment. Such substitutions, as said above, are inconsistent with the freedom of contract norm. Also, parties prefer their own solutions to court solutions.

Contract codes contain standards, though parties dislike them, for institutional rather than substantive reasons.<sup>15</sup> Drafts of contract codes, or sets of governing principles, usually are prepared by private groups, composed of professors, prominent lawyers and civil servants. The drafts are then submitted to legislatures. The private groups recommend standards to legislatures for four reasons. First, let the heterogeneity problem preclude creating a rule. Then the private group's choice is to recommend a standard or to recommend nothing. Since the heterogeneity problem often exists, the choice to do nothing may cause the public to think that the group is shirking or incompetent. Private groups often would rather *appear* to do something than be recognized as having done nothing. Second, because standards are written on high levels of abstraction courts and other decision makers may want to know what the underlying purpose behind particular standards was. Creating a standard thus can be profitable to individual members of the private group, such as law professors, who may be retained to "explain" the standard to courts.

Third, private groups prefer a standard, though a rule is possible, when the issue is controversial. Rules often reflect transparent policy choices. A standard is desirable when the creating group prefers not to choose but also prefers not to appear afraid to choose. The public may fail to see that promulgation of a standard did not resolve the controversial issue. Fourth, standards

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<sup>13</sup> A section of a code may permit a party to take an action unless the action would be "unfair".

<sup>14</sup> See Schwartz and Scott (2003), *supra* note 2.

<sup>15</sup> This and the following paragraphs are based on Alan Schwartz and Robert E. Scott, "The Political Economy of Private Legislatures", 143 Univ. of Pennsylvania L. Rev. 595 (1995). This article is fifteen years old, but the institutions it analyzes are unchanged.

delegate policy choices to courts. These delegations are attractive to the law professors and judges who participate in private groups. A law of standards increases judicial prestige, increases lawyer prestige and, as said, creates profit making opportunities for lawyers.

Legislatures often accept the recommendations of private groups in business law areas. A legislature may think that a contract code, for example, raises only technical legal issues that it is appropriate for private experts to resolve. Also, individual legislators may prefer the vagueness of standards to the concreteness of rules for the same reasons that member of private groups do.

To summarize, the benefits that a standard could create for parties would almost always exceed the costs of creating the standard. Thus, when a contract could have contained a standard to govern an issue but did not, the best inference is that the standard created no benefits. Contract codes largely are composed of standards. It follows that contract codes supply parties with default terms that do not maximize expected gains from trade. Standards do advance the interests of the legal profession, but a commercial law is supposed to advance the public interest. A contract code that realized its social justification therefore would contain many fewer sections than the codes that now exist.

## 7. Conclusion

This Lecture has reviewed the functions that a contract law serves, as that law applies to business contracts. It argues that two of these functions are of first order importance for the efficient functioning of a commercial economy. The *enforcement function* encourages party investment and permits parties better to plan their affairs. The *interpretation function* authorizes courts to resolve the inevitable ambiguities that attend written contracts. An argument that courts should enforce and interpret contracts is not controversial. This Lecture goes on to argue, however, that enforcement and interpretation are *all* that courts should do.

Courts should not police business contracts for procedural and substantive fairness. The motivation for procedural policing is sound. Many contracts are created under less than ideal conditions. Parties may lack information or face monopoly power, as examples. The problem with procedural policing is institutional. The state's goal should be to ameliorate procedurally defective conditions, but courts cannot implement the needed reforms. As an illustration, firms may lack particular information because the costs of acquiring it are high. The remedy is to reduce acquisition costs by creating standard formats for disclosing information. Courts cannot do this. No legal institution should police business contracts for substantive fairness. Such policing is inconsistent with the freedom of contract norm and makes parties worse off.

A large majority of contract law is composed of the rules and standards that contract codes contain. Rules are desirable for regulating contracting behavior, but courts and legislatures seldom



can create them. Statutory rules are written for the general case, but efficient solutions to parties' contracting problems are parameter specific. A legislature cannot create rules that govern just one or a few contractual relationships. As a consequence, contract law is largely composed of standards. Parties are told to behave "reasonably", "fairly", "in good faith", and so forth. It is costless for parties to create these standards in their own contracts, but they do not. Hence, a law of standards is a law that parties reject.

This conclusion is resisted by professors and judges. These agents enjoy the power and prestige that a law of standards creates. The judges are happy because legislative standards delegate law making to them, and professors are happy because they are made keepers of the sacred flame. The locus of power for a business law, however, should lie with private parties. These parties are generally competent to govern themselves, and they work under the harsh discipline that mistakes are punished with profit loss and bankruptcy. Much contract law is unnecessary, and sometimes is harmful, because the law empowers public officials and lawyers rather than private firms.